INTERNAL CONTROL -- A MANAGEMENT MANDATE

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PREFACE

Internal control is a broad term -- many use it; all accept its importance -- few understand it fully. The definition of the term itself is indicative of the broadness of the subject. The scope of internal control covers the complete cycle of the business organization and includes a myriad of individual elements welded together to form a solid line of control.

The area of internal control was selected as a thesis topic because of its apparent application to the everyday problems of management. Today, when we are constantly faced with cutbacks in personnel and funds, coupled with an increased workload, it is all too easy to bypass the principles of control, intentionally or unintentionally, in the all-out concentration on meeting deadlines. Internal control plays a major part in the effective performance of the organizational plan and adds to the assurance with which managing executives can direct the efforts of their organizations.

This thesis is directed to the attention of the command and supervisory levels of organization, with the major objective being to further the understanding and appreciation of this important concept of management. It is not a checklist of "do's and don't's" with respect to specific individual problems, but rather, deals with the general over-all problem of internal control, its scope, elements and effects. In bringing together some of the recent thoughts on the subject along with actual examples of poor internal control, I feel hopeful that some constructive benefit will accrue to those who might read it.

I am deeply appreciative for the wholehearted cooperation and assistance that I received from all of the persons contacted during the research phase of this thesis. Particularly helpful were the personnel from the offices of the Inspector General of the Supply Corps, Audit Division of the Navy Comptroller's Office, the Navy Management Office, and Mr. Cutler and Miss Haggert of the library staff of the Bureau of Supplies and Accounts library.

The most inspiring thanks is due to the many leading business and governmental executives who took their own time to speak before the Navy Comptrollership Class during this past year. Each one has contributed heavily to the subject matter that has gone into the make-up of this paper. To them I am greatly indebted.

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CHAPTER I

THE SCOPE OF INTERNAL CONTROL

> The delegation of authority and the issuance of orders and instructions by a person in the Naval Service shall not relieve such person from any responsibility imposed upon him. He shall insure that the delegated authority is properly exercised and that his orders and instructions are properly executed.[1]

What does this mean to the Naval Commander and to other persons in positions of responsibility? Simply, it means that once charged with a specific responsibility, no person can be relieved of that responsibility by merely delegating it to another person further down in the chain of command. The specific task or function may certainly be delegated to subordinates, but the superior must still remain responsible for the satisfactory completion of the task or function.

It would appear then that this requirement places a great burden on the shoulders of our Commanders, and it does. However, it is also a well established principle of management that no organization can function effectively without the delegation of sufficient authority throughout the organization to enable subordinate levels to carry on the tasks which each has been assigned, to the end that the mission of the activity can be accomplished on time and at a reasonable cost. The thesis of this paper is that with the necessity of delegation comes the need for control.

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[1]U. S. Navy Regulations, 1948, Art. 1318.

The Committee on Auditing Procedure of the American Institute of Certified Public Accountants has set forth what is perhaps the most widely accepted definition of internal control, and this definition has served as the focal point around which I have based this chapter. The committee wrote:

> Internal control comprises the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, *promote operational efficiency, and encourage adherence to prescribed managerial policies*.[1] (Italics mine.)

Contrasted to the definitions offered by two other leading theorists, Victor Z. Brink and John B. Thurston, the committee's definition is slightly broader than the meaning sometimes attributed to the term. Brink states:

> Internal control refers to the design and utilization of all of the means whereby, from a financial standpoint, management is enabled most effectively to safeguard the company's assets, administer the current operations and plan for the future.[2]

Thurston writes:

> Internal control is defined more broadly as the scientific distribution of duties and responsibilities which is made by an organization in order to establish a system of checks and balances so designed that the activity of one officer or employee independently performing his own prescribed work will check automatically, continuously, and with little or no duplication, the work of another or others. The result of this control is that assets will be safeguarded and all transactions will be fully and accurately reflected in the accounting or other records of the organization.[3]

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[1]American Institute of Certified Public Accountants, *Internal Control*, A special report by the Committee on Auditing Procedure. (New York: American Institute of Certified Public Accountants, 1949), p. 6.

[2]Victor Z. Brink, "A Program for Effective Internal Control," *The Internal Auditor*, March, 1952, quoted in Bradford Cadmus and Arthur J. E. Child, *Internal Control Against Fraud and Waste* (New York: Prentice-Hall, Inc., 1953), p. 4.

[3]John B. Thurston, *Basic Internal Auditing Principles and Techniques* (Scranton: International Textbook Company, 1950), p. 8.

The committee's definition appears to include a wider range of vision than described by either Brink or Thurston, in that it recognizes that a system of internal control extends beyond those matters relating only to the functions of the accounting and financial departments.

Robert H. Montgomery, who, before his death in 1953, was recognized as one of the leading figures in the field of accounting, felt that the general concept of internal control as expressed by the committee's definition should be classified into three major areas: Internal Administrative Control, Internal Accounting Control and Internal Check.

> Internal Administrative Control -- Internal Administrative controls originate in and are usually conducted by operating departments other than financial or accounting. Certain administrative controls may be based on data or information such as operating budgets and reports of expenditures for plant additions furnished by accounting or financial departments. On the other hand, internal administrative controls, especially those of a physical nature, may replace or supplement internal accounting control or internal check procedures.
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> Internal Accounting Control -- Controls which "check the accuracy and reliability of accounting data" or, as the authors prefer to put it, controls which are designed to bring about accurate and suitable recording and summarization of authorized financial transactions, are logically described as "internal accounting controls." The responsibility for the installation, maintenance, and correction of faulty operation of such internal accounting controls is clearly that of the accounting (or financial) department. Equally clearly, such controls are of prime interest to the independent auditor who is to report on the fairness of the financial statements drawn from the records these controls are designed to protect.
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> Internal Check -- Internal check may be described as those accounting procedures or statistical, physical, or other controls which safeguard assets against defalcations or other similar irregularities. To the extent that such controls may be exercised through accounting procedures, or by proper assignment of duties within the accounting department or between the accounting department and other operating departments which furnish data for recording financial transactions, the accounting department is responsible for their installation and maintenance. Some of the usual forms of internal check of a physical nature such as fences, gates, watchmen, and inspection of outgoing material or personnel, are ordinarily the responsibility of other operating departments.[1]

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[1]Norman J. Lenhart and Philip L. Defliese, Montgomery's Auditing (8th ed.; New York: The Ronald Press Company, 1957), p. 54.

While all of the aforementioned definitions, refinements and ramifications are important in their own right and accurately describe the area under discussion, I believe it ineffective to describe internal control by mere definitions. Internal control, if it is to be effective, must be recognized as a dedicated frame of mind through which the true spirit of the philosophy of internal control emerges, and not just the automatic reaction of going through the motions because the "book" requires it. Internal control is not to be just "tolerated" -- it must be actively encouraged. The assurance with which the command operates bears a direct relationship to the system of internal control and the compliance with this system by all personnel in the organization.

Thus, with the topic of internal control brought more clearly into focus, the need for enlightened leadership should become more and more evident. No machinery can function properly without supervision and care, whether it be an internal control system, an engineering apparatus or a Naval Command. Furthermore, regardless of the degree of perfection achieved in the design and operation of a system of internal control, a watchful eye is required to continually appraise the system and improve it whenever and wherever necessary.

Right about here, many readers may stop and say: "We've got so much control now that we can just about operate." To this statement I reply, "Are you sure?"

The files of the Inspector General, and the audit reports of the Navy's Internal Audit group and the General Accounting Office are replete with facts and figures that came as a surprise to many an accountable officer or his immediate commander. Their dismay was not the fact that unsatisfactory conditions could come up, but rather that the conditions turned up in their

own bailiwick.

Internal control is not a panacea to eliminate all organizational ills, but operates as a tool for management to enable the responsible individuals to control their operations through their organizations rather than being forced to carry the complete burden alone.

Furthermore, the problem of internal control is not unique to the services. Civilian industry and almost any other form of organized venture is faced with a similar problem of building and enforcing a system of control that provides maximum control and minimum operational interference.

While there is a wide range of opinion as to what constitutes a satisfactory control system, it is conceded by all that no system can be designed to fit all organizations everywhere. Controls should be tailored to meet actual situations while conforming to the pattern of operations of the organization and the doctrines handed down from higher echelons, and the final control plan should be a set of integrated elements and not merely a collection of separate unrelated items thrown together in a casual manner.

No attempt will be made here to expound on the virtues of any one system or for the control of any one segment of an organization. The elements to be covered include the characteristics which should be incorporated in any integrated system with varying degrees of emphasis placed on the individual elements, depending upon the immediate needs and particular circumstances of the organization and the desires of its chief executive officer.

CHAPTER II

ELEMENTS OF INTERNAL CONTROL

> Briefly stated, the objectives of a system of internal check and control are to protect a company's assets against irregularities, to ensure the accuracy of recorded transactions and to assure management that the information on which it must base decisions is authentic and reliable.[1]

In this regard it is important to recognize that the various elements of control are complementary and result in an integrated system of control wherein the aforementioned objectives can be fully materialized. Individually, each of the separate elements are important in its own right, but the system gains its stature from the interrelationships between all of the elements rather than from any one element. Any serious shortcoming in any one area drastically reduces the overall effectiveness of the system.

Once again the leading theorists seem to differ to some extent as to the detail of the various elements of internal control that go into the make-up of the overall system. I feel, however, that the areas of difference apply more to the emphasis that each places on the individual elements rather than any material difference in the basic philosophy. The basic elements apply to almost all situations and to all systems of internal control.

Bradford Cadmus and Arthur J. E. Childs, working in conjunction with the Institute of Internal Auditors, have compiled what appears to be a

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[1]W. A. Walker and W. R. Davies, Industrial Internal Auditing (New York: McGraw-Hill Book Company, Inc., 1951), p. 21.

compendium on the subject. In their book Internal Control Against Fraud and Waste, Cadmus and Child outlined the elements as being:

Organization Structure

Procedures

Accounting and Other Records

Reports

Standards of Performance

Internal Auditing[1]

In addition to the above elements, I believe that the selection and training of personnel (which Cadmus and Child included as part of the element of organization structure) is a significant part of the control system and warrants inclusion as an additional element. Thus, with the inclusion of personnel selection and training, the elements covered herein seem appropriate to the subject. They cover the complete business cycle from planning (organization structure, procedures, selection and training, and standards) through the summarization of operations (accounting and other records) to evaluation of performance (reports and internal auditing).

There are many facets to each of the basic elements and many variations possible in the adaptation of these elements to any control system. However, since this paper is primarily designed to cultivate an appreciation of internal control rather than to outline detailed control programs, only a brief condensation of each element will be included.

Organization Structure

No organization can function effectively without the specific, clear-cut delegation of authority and responsibility throughout the organization.

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[1]Bradford Cadmus and Arthur J. E. Child, Internal Control Against Fraud and Waste (New York: Prentice-Hall, Inc., 1953), p. 15.

This element is considered by many authors to be the key to successful control.

In developing the structure of organization, the top management establishes the framework of the control system. Authority and responsibility are specifically delegated to the various units, set up in the organization, thereby enabling management to know just who is responsible for each segment of the operation and making possible the measurement of performance of each unit, both individually and collectively.

There is one cardinal rule of organization that must be rigorously followed, and that is the requirement that no one individual shall have complete authority and responsibility for handling all phases of any business transaction from beginning to end. There must be a definite separation between the operating, custodial and accounting functions. Without this built-in automatic check there can be no control. This fact has been brought out in numerous cases of fraud and deceit, wherein one person had been in complete charge over the custodial (or operating) and the accounting phases of one transaction. (These shortcomings will be discussed in more detail in the next chapter.)

The principle of separation goes a bit further than formal organizational separation. The separation must exist in fact as well as on paper, since even informal domination by one department of the organization over its control point can reduce the effectiveness of the over-all control system.

This last statement is not intended to convey the approval of the erection of impassible barriers between departments. It is, rather, a call for departmental independence in regard to the internal checks and balances while still recognizing the need for complete cooperative effort in meeting

over-all organizational objectives. On paper this plea appears superfluous; but in too many cases it is quite realistic. Organizations are made up of people with different individual temperaments and personal goals. It takes a truly dedicated man to accept the division of authority that is required of the control system and still contribute unselfishly to the common objective. No manual, textbook or directive can achieve this unity of organization. It must be bred into the organization by the top management and constantly nurtured. While this aspect is more related to personnel psychology than to internal control, it is, nevertheless, vital to the success of the organization.

Procedures

Procedures are designed to serve as guidelines to properly sanctioned methods of operations. Through the use of procedures, the actions of the various departments handling a specific program or problem are coordinated, and existing practices are analyzed, simplified and standardized. Procedures also serve as a valuable means of communication, setting forth to all sections concerned the specific responsibilities and duties assigned to each and the prescribed manner to carry out the assigned duties.

Effectively designed procedures anticipate problems in advance and work out acceptable solutions from the over-all company point of view, thereby reducing the need for snap judgment, trusting to memory and oral instruction. Continuity of operations is also enhanced since written procedures supplement other methods of training new employees, particularly where the change-over is sudden and not anticipated.

Coupled with an evaluation of the organizational structure, an evaluation of existing procedures will provide a detailed picture of the

internal control system established within the organization. A careful study of procedures concerning a particular subject area can determine whether any overlapping, duplication, obsolete steps or inefficiency is evident in the operation. Procedures can also be objectively evaluated to determine the extent of internal control provided and point up areas which should be amplified or changed to provide better control. Poorly designed procedures can, in themselves, lead to fraud or waste while overelaborate procedures can lead to an increased cost of operation by requiring greater control than is necessary. Simple test checks can easily determine whether or not the established procedures are being followed, and more important, if not, why not.

Procedures are necessary; however, they must be written in such a manner and in such language that they can be reasonably understood and put into action by the personnel who must actually carry out their provisions. Policy directives from higher echelons should be supplemented by local instructions which interpret the policy in terms applicable to each specific job in the organization. A well conceived plan of action is worthless unless each person handling the detail is cognizant of his every obligation. This is particularly true in relation to internal control. An employee who has the responsibility to police a built-in control mechanism and who fails to realize the significance of his position can compromise the system.

In order to keep pace with the organizational expansion and the general development of the situation, the existing procedures should be the subject of continual research and investigation. Organizations should be constantly searching for methods that will result in a better operation, lower cost, or both.

The development of procedures leads to the publishing of procedures and accounting manuals as well as the design of related forms and records.

Accounting and Other Records

Accounting is perhaps the oldest and most common form of management control, and even though other elements of control have been perfected, accounting remains as the backbone of the control system. Without reducing the business transaction to written or printed records, control becomes nebulous and accountability becomes non-existent.

In effect, the accounting system is an operating model (using the term originated by the new science of Operations Research) of the organization which enables management to feel the pulse of the business operation. An effectively designed system of accounting transforms what management observes in the daily operation of the business into financial reports which enable management to make decisions affecting future operations. In this respect, control through accounting goes much further than financial accounting; it delves into the operating areas and serves as a potent management tool.

Accounting can do much for an organization. It can keep management informed and up-to-date on operating and control matters, assisting in the attainment of the over-all company objectives. However, in order to reach this high plane of utility, the accounting system must be geared to furnish the information that management needs (or desires) on time, and in such form as can be readily understood and interpreted by management. In addition, the accountant must know what is behind his figures in terms of the operating performance of the business and he must realize that accounting only records and reports facts; it does not administer the business.

Management, in turn, should know what services are available through the accounting system and cooperate in the determination of the information that is to be collected in the accounts and other related records. Much of the information collected will be specifically required by Federal, state or local regulatory agencies, or by higher management authorities, but management must still be aware of the valuable services available through accounting. More important, management should use these services.

As a control device, accounting offers various techniques for the collection and verification of business transactions, including general financial accounting, cost accounting, and budgetary accounting. The accounting system should be designed to collect data in order to present the facts pertaining to the delegated areas of responsibility. Under this concept of responsibility accounting, all items entering the accounts and all physical properties owned by the organization are assigned to the specific area of responsibility of one executive or supervisory employee who is responsible for the operation of the applicable cost center. The accounts should differentiate between items over which the executive has complete control and the items over which he has no direct control but are assigned to his department as his share of the total organization-wide expenses. This plan highlights to the supervisory executive, any unusual items over which he has direct control, offering him the opportunity to investigate and correct unsatisfactory situations.

With the organizational separation of accounting from the operation and custodial functions, a high degree of independence is built into the control system. With proper distribution of responsibilities within the accounting department, the work of one employee should automatically check the work of

another, each operating independently and not duplicating the work of the other. The normal distribution of job assignments required by the magnitude of paper work usually provides sufficient separation of duties so that no one person has complete control over transactions or the records established to account for them.

It is virtually impossible to design a system of accounting that is error-proof. Errors will occur regardless of how good the system is or how intelligent and well-trained the personnel may be. However, careful selection and training of employees working under proper supervision in a system that provides for the organizational separation as previously discussed, can minimize the number and type of errors.

The necessity for any specific internal accounting control procedure will vary with the nature of the business and the circumstances. Some suggested procedures may be impractical; others too costly. Good judgment plays an important part in tailoring the accounting system to the specific needs of the business or organization.

The logical culmination of accounting effort lies in the preparation of internal management reports and the financial statements.

Reports

Reports are working tools of operating management and are essential in providing the information management needs to make factual appraisals of the multitudinous operations normally found in large organizations. In addition to providing factual information, the reporting system serves as an effective means of communication and of control.

The first consideration in the development of an effective reporting system is to determine the specific information required by management.

Reports should be designed to meet the requirements of the management levels for which they are intended and expressed in the language of the using activity rather than in technical accounting terminology. Without coordinated guidance in the determination of requirements, the reporting system will turn out either a minimum of reports or a mass of data from which management must ferret out the information it seeks. In either case, management is not realizing full benefit of the investment in the accounting and report system.

Reports must present a clear and sensible statement of relevant factual data and must be accurate. Such accuracy should be representative of the situation and not so minute that it is beyond the needs of the user. While the detailed accounting records should fully substantiate any data presented, reports detailing the data to the nearest penny are certainly not required when management only needs information to the nearest hundred or thousand dollars.

In order to maximize effectiveness, reports should be timely. Information is virtually useless unless it is in the hands of someone who can use it in time to take management action, as required. Delayed reports lose their value and often their validity as well as their significance.

Reporting is costly. Reports prepared on a regular basis when the information contained in them is only required sporadically should be discontinued on the regular basis and prepared as required. In addition, the need for reports should be examined periodically to determine whether the reports are serving any useful purpose or whether they are merely being filed for future reference. When asked the question, "Why is this report prepared?", the answer, "I don't know, we've always done it this way" is all too frequent.

It is the comptroller's responsibility to furnish management with all of the information it requires, but it is management's responsibility to use all the information it receives or reduce the requirement.

As a control device, reports highlight deviations from planned performances, but in themselves cannot correct an unfavorable condition. After the reporting of a condition that requires attention, it becomes management's responsibility to see that the reported condition is not overlooked and that a further analysis is made to determine all the facts in the case and to take corrective action where necessary.

Reports achieve maximum control utilization when results of actual performance are measured against predetermined standards of performance.

Standards of Performance

Standards of performance provide the necessary information on which to base comparisons of actual performance against expected performance. These comparisons allow management to analyze deviations from the standard and to take corrective action when and where necessary. The value placed on the deviations so determined, depends primarily on the methods and the judgment used in the preparation of the standards.

A standard of performance can take any form providing it represents some sort of a yardstick for measuring current operations. Naturally, some methods are more sophisticated than others and thereby provide a better comparative basis than some of the less scientific methods. The important fact, however, is that all operations should be measured against a predetermined objective in order to evaluate the results in an unbiased manner.

Perhaps the most elementary form of comparison is a historical comparison of the present operating period against a previous period or an average of previous periods. Such a comparison furnishes considerable information to management but the value of this information is somewhat restrictive and limited. Historical data are seldom any real indication of what could have been accomplished in the past or of what should occur in the future. However, such a comparison is better than none at all and is widely used in commercial enterprise.

Comparisons of actual results against budgeted performance appear to be a bit more reliable than historical comparison. A properly designed budget should weigh the historical results with expected improvements or other conditions affecting current operations and allow for a more valid evaluation of current operating results. Budgetary comparisons, however, are still somewhat limited in their value. Budgets must be prepared for some period in the future in which all conditions are not fully known and which are subject to continual change.

The most reliable standard of performance appears to be the introduction of engineered standards into the system of control so that a comparison of actual results is made against a predetermined standard of what should have been accomplished. The use of engineered standards coupled with continual review of the methods and procedures offers a maximum of managerial control over operations. Deviations from standard can be pin-pointed to specific areas of responsibility where corrective action can be taken immediately.

Unfortunately, a system of engineered standards is expensive to install and difficult to administer. Engineered standards are potentially one of management's best weapons with which to combat the ever-mounting effect of

inflation. Increased efficiency and higher production at lower cost usually follows the installation of realistic engineered standards.

Once the over-all operational plans have been developed and approved by top management in the form of an operating budget based on engineered standards (or on some other management approved measurement system), reports to management need only point out deviations from the planned performance. Thus, management is relieved of the burden of weeding out the areas of concern and can, therefore, spend full time and concentration on the areas that need attention. Furthermore, outstanding performance can be fully recognized and rewarded while substandard performance becomes the target of management action. This results in fewer but more potent reports, at a more reasonable cost, accomplishing more and better results in a shorter period of time.

Of course, standards must be continually appraised in light of better methods of operation, newer materials, and the introduction of modern labor-saving devices.

Selection, Training and Supervision of Personnel

The extent to which the organization will succeed will depend largely on the selection of officers and department heads of proven ability and experience, and operating personnel capable of carrying out the prescribed procedures in an efficient and economical manner. Personnel placement within the organization should be such that each employee is positioned where his talents, interests, and abilities can contribute to the maximum effectiveness of the total organization. This placement requires the study of all positions within the organization, the study of the qualifications required of the persons to fill these positions, and the determination of means whereby the quality of the employee's performance may be measured.

Careful selection of personnel for each position is the key to effective management and control. Here we are concerned mainly with the caliber of men who are considered for promotion. Most organizations are dedicated to a policy of promotion from within, a policy under which an error at any point of initial employment or promotion will be perpetuated to higher and more crucial levels. If competent people are overlooked, the potential of the organization will not be fully realized. If care and discretion are not used, selections for jobs on up the ladder will be made from second rate material.

Once selection has been made, the employee must be trained in his new position so as to promote efficiency of operation and continuity of control. The initial training should impress the necessity of strict adherence to approved procedures and controls as well as other details of the job. This, however, is a delicate part of the training process and must be handled in such a manner that personal initiative is not stifled nor the employee's capacity to think and reason retarded. Proper training enables each employee to know exactly where he stands in the organization and how his job contributes to the effectiveness of the organization and the control system. Control procedures should be explained in detail and fully understood by the trainee. Unless the trainee understands why he performs his duties in the prescribed manner, he is likely to circumvent certain control procedures which to him seem unimportant but which are integral parts of the over-all control system.

In this regard, the responsibility of supervision in the middle and lower levels of management cannot be overemphasized. Proper review of subordinate's work, and the determination that all employees are following prescribed methods and procedures, is a responsibility of the line supervisor. Regardless of the other control procedures in force, daily supervisory control

provides one of the best deterrents to fraud and waste.

Training should not be restricted to new employees. All personnel in the organization should be actively encouraged to broaden their scope of knowledge and job efficiency. This stimulation of desire for self-improvement should be an integral part of the training function since broadened knowledge leads to greater understanding, better management and better control.

Internal Auditing

The Institute of Internal Auditors, in their statement of the responsibilities of the internal auditor, defines internal auditing as:

> The independent appraisal activity within an organization for the review of the accounting, financial, and other operations as a basis for protective and constructive service to management. It is a type of control which functions by measuring and evaluating the effectiveness of other types of control. It deals primarily with accounting and financial matters but it may also properly deal with matters of an operating nature.[1]

The primary objective of internal auditing is to assist management in achieving the most efficient administration of the operations of the organization.

The degree of success or failure of the system of internal auditing depends primarily on the personality, professional ability and judgment of the internal auditor, and the degree of independence with which he is allowed to operate. The independence that an auditor brings into the audit of an activity means unbiased judgment and objective consideration of facts as the determinants of his opinions. Independence is meant to represent an impartial attitude that recognizes an obligation on the part of the auditor for a fair presentation of facts and not the attitude representative of a policeman or prosecutor.

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[1]Institute of Internal Auditors, Statement of the Responsibilities of the Internal Auditor (New York: Institute of Internal Auditors, 1947).

An internal auditor must possess wide conceptual vision through which he must evaluate the results of his observations in terms of the effectiveness of management policy and procedures, and the extent to which they are followed by the personnel under audit.

It is not enough for an auditor to search out the system for errors and possible instances of fraud. The auditor must look beneath the outer shell of accounting and delve into the very existence of the activity under audit: examining workload, performance, adequacy of personnel and even adequacy of management itself.

For many years it was held as a general belief that the primary mission of internal auditing was to detect fraud. Modern interpretations no longer support this belief. While fraud is detectable through internal auditing, the cases of fraud detected by other elements in the control system will exceed by far those detected through internal auditing. In fact, most companies have come to realize that the detection of fraud is the responsibility of management and not of the internal auditor. Once fraud is suspected or detected, however, internal auditing offers a valuable service to determine the extent of the loss and to evaluate the causes that allowed the fraud to be perpetuated.

The auditor's certificate that appears on all financial reports filed with the Securities and Exchange Commission reads something like: "Our examination was conducted in accordance with generally accepted auditing standards and included all procedures which we considered necessary in the circumstances." The auditing standards referred to in the certification are the standards set forth by the Committee on Auditing Procedure of the American Institute of Certified Public Accountants, and are incorporated into this

paper to give the reader a better understanding of the audit function and the meaning of generally accepted auditing standards. They are:

General Standards

1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.

2. In all matters relating to the assignment an independence in mental attitude is to be maintained by the auditor or auditors.

3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

Standards of Field Work

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.

2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.

3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

Standards of Reporting

1. The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.

2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.

3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.[1]

With particular reference to standard #2 of field work (proper study and evaluation of the existing internal control), internal control requires a great deal of study and thought on the part of the auditor. Most accounting firms and many companies have internal control questionnaires which they fill out during the course of the audit. These questionnaires assist the auditors in their evaluation of the internal control and point out areas where audit

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[1]American Institute of Certified Public Accountants, Tentative Statement of Auditing Standards, Their Generally Accepted Significance and Scope (New York: American Institute of Certified Public Accountants, 1947), p. 11.

procedures may need to be extended or modified. The balance of the audit effort can then be directed to tests of the reliability of the information so received as well as tests of the accuracy of accounting records.

Responsibility for Internal Control

Actually, internal control is the responsibility of each and every employee in the organization, but since the old adage of, "Everybody's business is nobody's business" can be applied to internal control, the responsibility for the development and maintenance of the internal control system usually falls to the comptroller. Naturally, a great deal of cooperative effort is needed to blend all of the elements of internal control into an integrated system of control.

In this chapter I have attempted to present a brief summary of the elements of control, stressing the individual importance of each element in its own right and the interrelationships between the various elements. It bears repeating that the necessity for internal control is universal, but the emphasis placed on the various elements in the development and maintenance of the system must be determined by the nature of the business and the particular conditions found in that business. Good judgment plays an important part in tailoring the various elements of control to the specific needs of the business or organization.

It also bears repeating that internal control is not a panacea to eliminate all organizational ills, nor a substitute for managerial judgment. Internal control brings the unusual situation to the attention of management whereupon it becomes management's responsibility to take any action appropriate to the circumstances.

CHAPTER III

THE EFFECT OF INTERNAL CONTROL

Chapter II established the fact that internal control is the responsibility of management, and more specifically the responsibility of the comptroller and the chief executive officer of the organization. To effectively carry out the responsibilities of business in relation to internal control, management should understand the effects of the control system and some of the consequences of a poorly designed or administered system.

I am certain that the reader has heard of, or read about, cases where fraud or other similar form of loss had taken place. In many of these cases, the fraud was detected as a product of the control system. In other instances, the system had completely failed to deter or detect the fraudulent action; fraud was detected through action outside of the control system. In still other cases the defalcations are yet uncovered.

Management executives are frequently so tied up with every-day operational problems and decisions that they take it for granted that the assets of the company are properly protected and accounted for. The frequency of fraud and waste which continually arises in the business world, however, is justification for treating internal control as one of the major problem areas of business. In their book, The Thief in the White Collar, Norman Jaspan and Hillel Black report that light-fingered white collar workers are stealing about $4 million in cash and property from their employers every working day.

In 1959 alone Jaspan's management consulting firm unearthed more than $60 million worth of dishonesty in American companies. More than 60% of that total was attributable to supervisory and executive personnel -- not rank-and-file workers.[1]

To further the understanding of management officials in relation to fraud and waste, it is important that management know and understand the methods of defalcation so as to be able to recognize their occurrance and to recognize and correct the situations where these methods might be put to use by a dishonest "trusted" employee. In this regard, I will discuss the general area of fraud and review several case studies to show examples of fraud and waste that have occurred in both civilian and military organizations. Of particular interest will be the pointing out of the failures of the administration of the control system which permitted the occurrence of the act and the possible controls which could have been employed to prevent or detect the occurrence.

A commonly cited authority in the field of business law, Anson's Contracts, defines fraud as:

> A false representation of facts made, with a knowledge of its falsehood, or recklessly without belief in its truth, with the intention that it should be acted upon by the complaining party, and actually inducing him to act upon it.[2]

There is a very fine line of distinction between the various forms of fraud such as larceny, embezzlement, forgery and certain other statutory crimes, but for the sake of discussion here, I will use the general term of fraud to include any of the criminal acts of dishonesty or deceit, whereby the

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[1]"In Management," Newsweek, February 27, 1960, p. 109.

[2]W. R. Anson, Contracts (2nd American ed., Knowlton, 1887).

organization is deprived of property without its knowledge or consent.[1] The terms misappropriation and defalcation are also used to designate fraud, and while not part of the legal terminology, they are often applied to the general term of fraud.

The reasons for fraud have been the subject of many studies in the past and will be the subject of many more studies in the future. All that can be said for the reasons, however, is that the individuals concerned were not strong enough to resist the temptation of "easy money," and the internal controls were not sufficient to deter the acts. Highly respected businessmen have perpetuated frauds on their companies and the public in general, as have other personnel at all levels of organization. Fraud has been committed to cover larceny and embezzlement of cash, securities or merchandise, or to falsify financial position in an attempt to mislead others.

A compendium of all possible frauds is naturally prohibitive; however, the most common types of fraudulent acts can be grouped into five major categories including theft of merchandise, theft of securities, shipments of merchandise to fictitious customers, failure to account for cash receipts, and execution of fraudulent disbursements.[2]

Theft of Merchandise

Theft of merchandise is perhaps the most common type of fraud, the most difficult to detect, and even more difficult to prove. This is particularly true if the thefts are made in small quantities and spread over an extended period of time. Separation of physical custody of merchandise from accounting

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[1]Dwight A. Pomeroy, Business Law (3rd ed.; Cincinnati: Southwestern Publishing Company, 1948), Chapter XVII.

[2]Arthur W. Holmes, Auditing Principles and Procedures (Chicago: Richard D. Irwin, Inc., 1949), p. 123.

responsibility coupled with periodic inventory of merchandise, reconciled to the accounting records act as deterrents to theft. In addition, physical security affords a measure of safety and should include random inspection of packages and vehicles leaving the premise. A system of charge and discharge accountability, where such a system is practicable, also acts as a deterrent since responsibility for loss can be pin-pointed to a specific accountable individual.

Some inventory shrinkage is usually considered normal and expected. Management, however, must determine the limits of normal variation and take corrective action when the limit is exceeded.

Theft of Securities

Theft of securities is not too common and has no apparent government correlation. Again, the best safeguard appears to be separation of custodial and accounting functions, physical security and periodic reconciliation through audit.

Shipment of Merchandise to Fictitious Customers

Government disposal of surplus materials is big business. Many state, local, and educational agencies are allowed to draw material without reimbursement, hence no actual cross control from sealed bids, bid books, cash deposits and other controls. A fictitious request for surplus material, with material picked up by an accomplice will be forever recorded as donated material. Controls for this sort of action are difficult to devise and even more difficult to administer. Once again, the control should include separation of custodial and accounting responsibility, independent approval of such requests by an officer other than the disposal officer and periodic audit including confirmation of delivery to the agency authorized to receive donated

material.

Failure to Account for Cash Receipts

In government as well as in commercial enterprise the receipt of cash is an everyday transaction. Both appropriated and nonappropriated monies are received each day. Control of cash is important because of the ready accessibility to the cash and the temptation that this accessibility presents. Several methods have been devised to extract cash out of cash receipts. They include:

(a) The theft of cash from cash sales without the recording of the sale on a cash register or on a sales invoice. In small amounts, this method is very difficult to detect. Larger amounts will appear as excessive inventory shortages and put management on notice that an abnormal situation needs attention. This is particularly true in the case of nonappropriated fund transactions such as clubs, special service activities and retail outlets. A central cashier, receipt-printing cash registers, posted price lists, and alert customers deter this method of fraud.

(b) Lapping -- a technique which involves the withdrawal of current receipts without an entry being made on the records to record the receipt. When a subsequent receipt is received, the entry for the first receipt is made, and the later receipt is not recorded. This technique can be continued indefinitely or until the defrauder is discovered or makes good his shortages. Lapping is a favorite method of manipulation and usually begins with the idea of replacing the shortage within a short period of time. Lapping requires that the defrauder maintain what amounts to a set of books to keep up with the manipulations. The ease with which he can escape detection with small amounts often leads to larger and larger "withdrawals" until he can no longer effectively hide his manipulations.

(c) The theft of cash after it has been properly recorded in the record of cash received, followed by underfooting (a reduction of the total of the amounts) the cash received column in the cashbook, making this total agree with the amount of cash deposited in the bank. Verification of footings, a normal audit procedure, will disclose this fraud.

There are numerous other methods of manipulations of cash receipts common to commercial businesses that deal with customers' accounts, bad debt accounts, sales discounts and dividend payments. These have no particular governmental application, and will not be further discussed here.

Fraudulent Disbursements

Another favorite of the professional defrauder is manipulating the disbursement of cash to his advantage. Fraud of this type is more applicable to nonappropriated fund transactions than to appropriated fund accounts because the nonappropriated activities usually maintain their own banking accounts locally rather than use the government disbursing facilities. Some of the more frequent methods of manipulating cash disbursements include:

(a) The theft of money from petty cash funds. It is impossible to even estimate the number of fraudulent transactions perpetuated each year by "chiseling" on petty cash. Forged approvals on petty cash vouchers, fictitious claims with correct approvals, and duplicate submissions of vouchers with altered dates are usually submitted to cover the amount stolen.

The use of a petty cash fund gains its acceptance from the relative ease with which small purchases and minor expenses are handled. Over-control defeats the purpose of the fund. Under-control invites fraud and places the custodian in the throes of temptation.

Control of petty cash is aided by the requirement for all petty cash withdrawals to be approved by an employee other than the custodian of the fund as well as by establishing limits on the amount of petty cash that can be paid for any one voucher. Periodic audit on an unannounced basis further deters the temptation to defraud.

(b) Forging checks, cashing them and destroying the cancelled check when it is returned by the bank. This is possible when the cashier has access to the blank checks, the cashbook, and the cancelled checks when they are returned by the bank. This multiple opportunity frequently arises in special service activities and other nonappropriated funds where the office staff is small and the bookkeeper has access to the checkbook and also balances the bank statement. In addition to the forgery of the autorized signature, the cash disbursements book must be manipulated to show a higher amount than was legitimately spent, in order to cover the forgery.

Major deterrents include reconciliation of the bank statement by a person other than the cashier, control of blank checks, and routine verification of cashbook footings during internal audit.

(c) Raising the amounts of paid checks returned by the bank. The original disbursement is recorded at a figure higher than the amount of the obligation. The payee of the check is paid the proper amount with the cashier holding out the raised amount. When the cancelled check is returned by the bank, it is raised to include the amount stolen.

The use of check-writers or other mechanical means aids in the attempt to thwart the alteration of checks, but the separation of the responsibility for bank reconciliation from the cashiering duty is a more important deterrent.

(d) Altering the date on a paid voucher and presenting it again for payment. This is particularly effective when many purchases are made from the

same supplier so that the approving official would have little reason to question the propriety of the invoice. The defrauder receives the check after it is signed, forges the name of the payee and is in position to cash the check.

The mutilation of all invoices immediately after payment by the use of punched holes, defacing rubber "paid" stamps or other similar means along with the practice of direct mailing of checks to the payee upon signing can act to deter duplicate payments. This also holds true for fictitious vouchers where false entries are made supporting fictitious purchases.

(e) Kiting of checks. Check kiting is usually practiced to cover the theft of cash or to inflate a cash position on the financial statements, and involves the writing of a check on one bank and depositing the same check to the credit of the company in another bank. The check is not recorded as a disbursement against the funds in the first bank, but is picked up as a deposit in the second bank, probably as a deposit in transit. Check kiting is an art and not normally practiced by amateur embezzlers. It requires almost perfect timing so as not to arouse the suspicion of the auditor or of the bank being used as a medium of exchange. Successful check kiting results in all bank accounts being properly balanced while a loss has actually taken place.

Proper observance of procedures for the approval of checks, independent reconciliation of bank statements and unannounced counts of cash will often deter the check kiter.

(f) Manipulation of payrolls. The opportunity for fraud in connection with payroll manipulation is great, and various schemes have been used in the past and many will be used again in the future. Among the more common methods are: padding the earnings of employees, overfooting the payroll, padding the payroll with fictitious employees, leaving ex-employees on the payroll, and failing to record deductions from employee's wages. In the above frauds the

manipulator extracts the difference between the legitimate amount due and the amount of the raised payroll.

Hiring of employees, accounting for time, payroll calculations, check preparation, and finally payment of employees should each be handled by separate individuals or departments so as to reduce the possibility of manipulation.

There have probably been numerous other systems devised by the criminal mind to cover up the frauds of larceny, embezzlement or forgery. The methods outlined above have been repeated on numerous occasions. Management must learn to recognize the signs of fraud and the situations that lead to it; then develop means to reduce the possibilities. Conscientious adherence to the principles of internal control outlined in Chapter II should offer sufficient control procedures to deter the commission of any of the above types of defalcation. Notice that I say deter rather than eliminate. It is virtually impossible to design a workable system of internal control to operate at a reasonable cost which cannot be manipulated by someone with criminal intent.

There is also a second classification of fraud that involves false representation of pertinent factual information. These forms do not involve direct embezzlement, larceny or forgery and are perpetuated to show false financial position or false operating results. Usually frauds of this nature are committed by the officials of the company rather than by other lower level employees. The reasons for misrepresentation are to present a more favorable financial position so as to stimulate higher security sales, or to imply higher security to safeguard a proposed bank loan or mortgage, or to hide the results of the business operations.

Favorite methods used to carry out frauds of this type are: inflation of inventory valuations, inflation of investment and fixed asset valuations,

or the undervaluation of liabilities through either hidden liabilities or unrecorded obligations.

Frauds based on misrepresentation are difficult to control through the normal channels of the control system. If these are committed or sanctioned by higher management officials ultimately responsible for the control system, little corrective action would be undertaken. The only apparent control element which would be useful in cases of this sort would be an independent audit, where the report of audit would be submitted to a higher management level than the level held by the manipulator. In addition, honest employees observing or suspecting fraudulent manipulations by top management officials will often report their suspicions to higher management levels or to cognizant authorities.

Few readers would quarrel with the classification as fraud the instances wherein the inventory valuation of a business enterprise was overvalued to enable the company to borrow a higher amount of money than would be normally allowed by a prudent banker, or the deliberate understating of income so as to incur a lesser tax liability. On the other hand, how many respected readers would think it quite in order to hold out a legitimate obligation "just for a few days" until a new quarter or a new fiscal year when the obligation would put their activity in an overobligated status. There are different degrees of fraud, but in the final tally, the loss of integrity is the same.

On too many occasions, results are falsified because of the overwhelming emphasis on the importance of always being "on target." The consequences of failure are acute and the temptation to adjust reports of operations to indicate favorable tendencies is great. The pattern of results depends on the fair and equitable treatment by top management of each case

brought before it. A sincere, helpful attitude on the part of top management breeds confidence. Confidence in top management leads to integrity of reporting.

When actual fraud cases are studied, it appears unbelievable that the majority of the frauds could have been successful. Most are so simple that only the most gullible of executives should have allowed the frauds to gain foothold, let alone remain undetected for any length of time. You will notice that the great majority of defalcations occurred where one individual had complete control over all segments of the transactions through which the fraud was perpetuated. The following case histories include actual cases from the files of the Inspector General of the Supply Corps, the General Accounting Office, the Comptroller of the Navy, and other cases from the civilian business world as published in various books and periodicals. The value to be gained by such a review is to bring the theoretical appreciation of internal control down to the practical every-day world of reality. These cases have actually happened -- they will happen again, but to different companies and under slightly different circumstances.

The Looting of H. L. Green[1]

The saga of H. L. Green shows conclusively that fraud can be perpetuated at high levels, and indicates the responsibility of the board of directors in the system of internal control. H. L. Green should never have been "looted." Their loss firmly establishes the need for caution and control.

Maurice Olen, an extraordinary, energetic young man, had parlayed two small retail stores owned by his father into a full-fledged chain organization

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[1] T. A. Wise, "The Looting of H. L. Green," Fortune, March, 1960, p. 142.

of 123 stores scattered all through the southeastern section of the United States. At 34, Olen had earned the reputation as the boy wonder of retailing.

At the same time the H. L. Green Company was a plodding, woefully mismanaged enterprise, desperately in need of fresh blood. Sales were stagnant and profits declining at an alarmingly steady rate.

It was, therefore, only natural that the boy-wonder should meet up with the stumbling giant -- a meeting that resulted in a merger of the two organizations. The merger was completed in mid-1958, with Olen emerging as the president of the revamped organization. Both organizations were well satisfied. Olen had expanded his empire and H. L. Green had what it needed -- an energetic and imaginative chief executive.

The terms of the merger (proposed by Olen) were to exchange $26 worth of Olen stock (two shares of stock) for one share of H. L. Green stock selling around $31. Furthermore, since the book value (net asset value) of H. L. Green was over three times that of the Olen company, there was no doubt that H. L. Green was paying a premium in order to complete the merger.

In addition, the terms of the merger required a full audit of the Olen Company. Not wanting an audit by the Green auditors, Olen persuaded the Green board of directors that such an audit would be unnecessary since a local CPA firm was in progress of completing their audit of the Olen Division, and that this audit should be sufficient to meet the terms of the merger agreement. Olen proposed that the Green auditors merely review the working papers of the local firm rather than conduct another full audit. This was agreed to by the board of directors. Naturally, this cursory review failed to uncover any indication of things to come.

Later, when irregularities within the Olen Division began to materialize, Maruice Olen acknowledged that he had, at times, juggled his

accounts somewhat in order to comply with the terms of a loan. Olen stated that while he overvalued the inventories, he had also undervalued the fixed assets so that the total value was merely "rearranged" to suit his immediate needs. He was confident that the entire matter could be straightened out without difficulty.

A complete audit revealed that Olen had indeed undervalued his inventories -- by about $1.7 million, but in addition, conveniently secreted in shoe boxes, were unrecorded liabilities amounting to over $600,000. Thus, H. L. Green, which had already paid a premium to close the merger with Olen, received $2.3 (and perhaps closer to $4) million less than it originally believed worth at the time of the merger.

H. L. Green is still beset with problems. Olen and the local Certified Public Accountant are awaiting trial on a Federal indictment charging criminal fraud. Regardless of the outcome of the trial, it is believed that Maurice Olen will again be back in business, a bit smarter perhaps, but none-the-less dangerous.

The looting of H. L. Green was a simple maneuver. Olen, the clever pitchman, had sold a bill of goods that was bought with only superficial investigation by the buyer. Any sort of investigation should have pointed up some of the irregularities. But, this is not the first time that fraud had been committed by a member of top management. The infamous McKesson and Robbins fraud case was also perpetuated by top officials of the company through inventory manipulation, and has stood out for many years as a shining example of fraud in high places. The directors of H. L. Green elected to ignore the lessons handed down by McKesson and Robbins and so paid a high price for a new experience in fraud.

Scandal in Disposal

Not to be outdone by our civilian counterparts, the Navy was victimized in mid-1959 by a middle-grade civil servant who was charged with the theft of over $250,000 worth of government surplus material found on his secluded farm home. An anonymous phone tip to the local state police unit ended about four years of almost flawless manipulation.

As disposal supervisor, the defrauder was in an excellent position to manipulate the disposal operation in almost any manner he desired. He had complete control over the physical custody of the material, the publication of sales catalogs, the receipt of sealed bids, the bid book (opening of the bids was conducted in accordance with prescribed regulations with two officer witnesses, including the disbursing officer), the invoices for the sales, and finally the reports of operation.

Among the several successful methods devised by the individual were forged requests for donated material. Several state and local agencies had been authorized to draw on surplus material of the Navy at no cost to the agency. The disposal supervisor had merely to forge a requesting letter purporting to be from one of the authorized agencies, prepare the necessary invoices, obtain any approvals that were necessary, then have an accomplice (his father-in-law) sign for the material as a representative of the agency. It sounds simple and it was.

In addition to family ties, the disposal supervisor formed an unholy alliance with several local dealers in government surplus material. Thus, as collusion entered into the scheme, the area of fraud was expanded and the opportunity to control fraud was considerably reduced. Detailed investigation revealed well-covered discrepancies in almost every area, including manipulation of the amounts on deposit with the disbursing officer.

This he did through fraudulent vouchers submitted to the disbursing officer indicating that money was due a bidder for unsuccessful bids, while he was certifying invoices that the bidder was successful. Thus, the "favorite bidder" not only received the surplus material but a good portion of his original deposit was also returned.

The benefit received by the disposal supervisor through this type of manipulation is not known at this time. Obviously, kickbacks or other forms of "payola" were included.

In some instances, the disposal supervisor managed to submit his own bids (using fictitious names of course) on cataloged material and on material not even listed on the catalog as being for sale.

These are by no means all of the methods through which he manipulated the transactions to his own benefit. The exact measures are not really important. The importance of the case lies in the determination of how the fraud was allowed to gain a foothold and the reasons why it was not detected through the normal processes of the control system.

The disposal supervisor was an energetic, likable person who knew the disposal operation better than anyone else on the station. As he became more and more familiar with the operation, other supervisory personnel allowed the supervisor to assume more and more responsibility. At the same time, the personnel under the disposal supervisor were not being fully trained in the over-all operation -- only in their own small realm of activity, with all decisions being made by the supervisor. Early in 1959 the organization of the Disposal Division was changed to place the disposal supervisor in complete charge of the operation rather than reporting to a Disposal Officer, a Supply Corps officer assigned as Disposal Officer as a collateral duty. Since the officer's primary duty required more than full-time attention, more and more

reliance was placed on the disposal supervisor, until the recommended reorganization was finally approved by the station's commanding officer.

With complete freedom to operate, anything was possible, that is, until some unknown party made the eventful phone call that wrote finis to the story.

That is the story of how it happened. Why was it not detected earlier? The supervisor was one of the hardest working individuals on the station. His honesty was unquestioned by any of his superiors or co-workers. Every inspection and every audit conducted on the station spent some time in his organization without uncovering any hint of irregularity. In fact, the internal audit team had even selected one of the fraudulent documents for test check and had failed to detect that something was amiss. All this led to a general feeling of confidence in the operation. The operation was successful; the supervisor had the trust and confidence of his superiors -- a trust he violated to further his own cause.

Was it worth it? I doubt it. At present the individual is awaiting trial along with his wife, her mother and father (who were accomplices to the fraud) and the members of the unholy alliance. The two young children of the couple have been placed in a home. The scars left on the children will never heal, regardless of the outcome of the trial or of the amount of money safely secreted.

The disposal supervisor alone knows why he violated the trust and confidence placed in him by his superiors. Perhaps the control system was too loose and the temptation of easy money was too great.

Procedural changes have been made in the organization, operating procedures, and audit practices. It is doubtful that this particular fraud will be committed at any time in the near future, but the conditions that build

up to present the opportunity for the fraud may be building up in another segment of some other activity. It can be blocked by conscientious application of accepted elements of internal control.

Inventory Loss[1]

At a small naval air station, a disturbing inventory loss was discovered when the priced-out physical inventory was reconciled with the financial inventory records. A test check of the inventory against the stock record cards failed to reveal any obvious discrepancy that would cause the large variation between the inventory and the financial records.

However, a detailed review of the entries on the stock record revealed that many issue entries on the stock record card referred to a fictitious issue document, a document which did not contain the item posted, or did contain the item but for a lesser quantity than was entered on the stock record cards.

It was later determined that, on occasion, it was necessary for the man responsible for the records to assist in the actual issue of material. Thus, an opportunity to steal the material and to make compensating entries in the stock records was presented to the stockman.

This theft was detected through the control measures of the internal control system, since management was made aware of the inconsistency between stock records and financial control records and an investigation was promptly initiated.

The case illustrates the need for careful selection of personnel and adequate supervision. In instances where dual responsibility for custody and accounting is necessitated by the smallness of the operation or the lack of

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[1]CDR. H. O. Durham, Jr., SC, USN, "Inventory Loss," Monthly Newsletter, Magazine of the Navy Supply Corps, May, 1957, p. 12.

personnel, frequent, comprehensive personal examinations of the operation by the cognizant supervisor is an inherent requirement for the satisfactory compliance with the system of internal control.

Audit Board Censure[1]

As the result of a fraud committed in the Commissioned Officers Mess (detected outside of the control system) a board of investigation reviewed the work of the audit board appointed by the station's commanding officer. The fact was quickly established that the audit board was derelict in the performance of its duty in that it failed to uncover mismanagement of the mess.

Among the failings of the audit board were: incompletely conducted inventories at infrequent intervals; failure to verify and count cash funds or reconcile bank statements; failure to retain working papers as a permanent record of the audit; and finally, lack of familiarity with the accounting system for the operation of the mess. As a result of the investigation, letters of censure were awarded the individual members of the audit board.

The audit function is an important element of the control system in that it furnishes an impartial and independent appraisal of the operation under audit. While audit board duty is usually assigned as an additional or collateral duty, this duty must be performed with the same application of effort and sense of responsibility as would be applied to a primary duty.

The senior member, an officer of the Supply Corps, through his negligent performance of duty, violated the trust and confidence placed in him by his commanding officer and caused the disgrace of the junior members of the board who looked to him for knowing leadership and guidance.

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[1]Lt. T. W. Jones SC, USN, Monthly Newsletter, Magazine of the Navy Supply Corps, September, 1957, p. 27.

Payroll Manipulation[1]

Through his thorough knowledge and experience in disbursing, the Chief Disbursing Clerk was relied on heavily by the new and inexperienced disbursing officer. Having complete control over almost all facets of the disbursing office except the actual cash, the chief was in an excellent position to manipulate the pay records -- which he did.

Operating without the knowledge of the disbursing officer, the chief manipulated the amount of pay due friends who needed special pay even though the individual had no pay "on the books." Having no reason to doubt the accuracy of the amount due, the disbursing officer would honor the pay receipt and make payment. For his share in engineering the manipulation of pay, the chief held out a share of the proceeds. While the Navy did not suffer in the long run from this activity since the full and proper amount had been entered on all records, the transaction was, in effect, an illegal loan on future earnings.

Ultimately, this led to further manipulations wherein the chief deliberately failed to enter payments on the pay record of certain individuals, and thus enabled them to receive duplicate payments, to be shared by the chief. It was no problem at all for the chief to make the amount paid by the disbursing officer agree with the amount of the pay receipts and the amount supposedly entered on the pay record. This he did by merely overstating the adding machine tape of the pay records by the amount of the fraud.

The fraud ended abruptly when the internal auditors made an unannounced audit of the pay records and found a minor discrepancy which

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[1]Interview with John Leech, Office of Navy Comptroller, April 9, 1960.

prompted them to investigate the records further. It was then determined that fraud had been committed.

Here again, the defrauder was a highly-trusted individual, well-versed in his work and eager to take on more and more responsibility. Coupled with an inexperienced superior who was unfamiliar with the need for control, fraud was ridiculously easy.

Throughout the Navy there are enlisted disbursing clerks with almost as much opportunity for manipulation as was had by the chief in the above case. While most disbursing officers check the amount paid on special pay against the amount entered on the pay receipt to make certain that the payment is recorded, very few bother to have an independent check of the postings to the pay record on regular pay days. On too many occasions, two parts of the three way check (pay receipts, pay records, and cash paid out) are completed by the disbursing clerk. For proper internal control, the disbursing officer should insist that an independent party verify the postings to the pay records through an adding machine tape. Thus, while the possibilities of manipulation are not eliminated, they are drastically reduced.

This case again proves that those who are responsible for any operation should know the areas where fraud and manipulation are possible, then take steps to correct or eliminate the opportunities and the temptations those opportunities present.

There have been countless additional cases of fraud, both in government and in the civilian business world, but a continued analysis of inefficiency, fraud and careless attention to duty would appear superfluous. While management should recognize that fraud is always possible and should be wisely guarded against, I do not wish to convey the impression that the sole effect of internal control should be the elimination of fraud. The control system

removes as much of the temptation as possible from the employees and installs sufficient checks on the areas where temptation cannot be completely removed so as to deter the commission of any potential wrong doing; but, the primary objective of the control system should be the promotion of operational efficiency.

Fortunately, the vast majority of employees are inherently honest, but the lapses in the control system that allow fraud to go undetected in one organization, may also be allowing abnormal waste to go unnoticed for prolonged periods in another organization. Cases of fraud are spectacular and receive wide publication and interest. Cases of needless waste are all too frequently passed off with only mild rebuke without further investigation into the reasons for waste or correction of ineffective control measures.

The fact that more fraud and waste arises from defects in administration of sound systems of control than from inherent weaknesses in the systems themselves gives rise to the requirement for conscientious application of accepted principles of control and compliance to these principles by all personnel within the organization. Application and compliance puts life into the control system to the end that the assets are safeguarded, the accuracy of accounting data is reliable, operational efficiency is promoted, and adherence to prescribed managerial policies is ensured.

CHAPTER IV

THE IMPLEMENTATION OF CONTROL IN NAVY

The Naval Establishment is, to say the least, huge. Its organization permeates many levels and commands. Within the three principal elements of Navy (the Operating Forces of the Navy, the Navy Department, and the Shore Establishment) control takes many forms. At the higher levels, the controls exercised fall more into the category of managerial control than into the more restrictive area of internal control. Managerial control has a much broader interpretation than internal control and includes internal control as one of its elements.

The area of managerial control in Navy is rather well defined, both in the legal sense of substantive legislation and in the sense of assignment and distribution of authority and responsibility for the administration within the Department of the Navy. However, the responsibility for internal control is rather broadly included under the heading of "business administration." Described in General Order No. 5, the task of business administration is "to develop and maintain efficiency and economy in the operation of the Department of the Navy with particular regard to matters of organization, staffing, administrative procedures, the utilization of personnel, materials, and facilities, and the budgeting and expenditure of funds."[1]

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[1]Office of the Secretary of the Navy, General Order No. 5, SECNAV NOTICE 5430, 14 May 1959.

The responsibility for assuring that the business administration and management of the Department of the Navy is carried out in an efficient and economical manner is delegated to the Undersecretary of the Navy, who also holds the title of Comptroller of the Navy. More specifically, the Undersecretary is charged with the responsibility for financial management of the Department of the Navy; policy, management and control of the functions of budgeting, accounting, financial, progress and statistical reporting, and internal auditing throughout the Department. In addition, he supervises and directs the work of the Naval Inspector General related to the business administration and management of the Navy.[1]

As stated in the Charter of the Comptroller of the Navy, the discharge of the above functional areas will include responsibility for:

> (a) Development and establishment of basic fiscal policy and supervision of the execution thereof.
> (b) Budget Preparation: This responsibility extends to the technique and authority essential to the translation of policies, plans, and programs of the Secretary of the Navy, the Chief of Naval Operations, and the Commandant of the Marine Corps into a formal budget for presentation to the Secretary of Defense, the Bureau of the Budget and the Congress. The duties and responsibilities of the Comptroller in no way diminish the military authority of the Chief of Naval Operations and the Commandant of the Marine Corps through the military chain of command over operating forces and their essential support, including personnel distribution, military organization methods, and general military procedure. The Comptroller's organization shall assist the Chief of Naval Operations and the Commandant of the Marine Corps in the performance of such duties and the satisfaction of such responsibilities as they may have in connection with preparation and presentation of the budget.
> (c) Budget administration, including a continuing review of the execution of approved budget plans and programs, and the allocation and apportionment of appropriations.
> (d) Allocation and control of civilian personnel ceilings.
> (e) Determinations with respect to, and the administration of, the guaranteed loan program, advance and progress payments, and other credits relative to procurement contracts.

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[1]Office of the Secretary of the Navy, Assignment of Duties and Responsibilities SECNAVINST 5430.7C, 12 August 1959.

(f) Development and supervision of the execution of principles, policies, and procedures to be followed in fiscal, accrued cost, capital and operating property, and working capital and management funding accounting throughout the Department of the Navy. Nothing herein shall be construed as divesting the Chief of Naval Operations, the Commandant of the Marine Corps and the bureaus and offices of the Navy Department of their authority and responsibility with respect to inventory control, the determination of stock levels and distribution, and the physical items of property embraced therein.

(g) Prescription of the type and content of basic fiscal, cost, capital and operating property accounting records to be maintained by the bureaus and offices of the Department of the Navy and the Headquarters, United States Marine Corps whether appropriated or non-appropriated funds.

(h) Develop and coordinate data processing techniques and applications to a single integrated accounting system and associated reporting systems throughout the Department of the Navy.

(i) Development of audit principles, policies, programs, methods and procedures; performance of both contract and internal audits; performance of special audits and examinations as required for special purposes; rendering cost analysis and procurement liaison assistance in connection with the negotiation of contracts; and rendering advice to procurement authorities on accounting and auditing aspects of procurement directives and contracts.

(j) The development of policy and general systems of statistical and progress reporting, primarily with respect to fiscal and budgetary matters. The receipt and review of requests from theDepartment of Defense and other Government agencies for statistical data and the monitoring of completion and consolidation of these reports, when necessary.

(k) Reports control policy and the general implementation thereof with respect to matters under the cognizance of the Comptroller.

(l) Administrative organization structure and managerial procedures relating to budgeting, accounting, progress and statistical reporting, and auditing within the Department of the Navy.

(m) Making available to management information collaterally generated through normal functioning of the Comptroller organization.

(n) Technical control over military pay and allowances and travel.

(o) Coordination and correlation of matter under his cognizance with the Comptrollers of the Department of Defense, Army, and Air Force and other departments and agencies of the Government.

(p) Exercise management control of central and regional accounting, disbursing, and audit offices.

Orders and instructions issued by the Comptroller of the Navy in execution of the duties assigned to him by law, by this charter, or by other directive from higher authority shall be considered as emanating from the Secretary of the Navy, and shall have full force and effect as such.[1]

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[1]Office of the Under Secretary of the Navy, Charter of the Comptroller of the Navy, Approved 12 June 1959.

While the Office of the Comptroller of the Navy exercises a powerful hand in the determination of fiscal policy, a good deal of discretion is left to the individual bureaus and offices which exercise management control over the various segments of the Navy. This is in keeping with the policy of the Secretary of the Navy in assigning objectives and responsibilities to and among the Chief of Naval Operations, the Commandant of the Marine Corps, and the chiefs of bureaus and offices so as to permit these officials to exercise maximum executive authority over the work of their departmental and shore activity organizations.[1]

The amount of detailed control exercised by the bureaus varies from bureau to bureau, but with the advent of ultra high speed communication and data processing systems, control is becoming more and more centralized. The bureau establishes the mission of the field activity (subject to the approval of the Secretary of the Navy), approves its organizational structure, controls the distribution of funds, the manpower ceilings, the technical aspects of the operation, establishes uniform standards of performance and closely follows the operation of the field activity through reports, staff briefings and staff inspections. The bureau controls the men, money, and materials; but the actual culmination of internal control as depicted in this dissertation rests with the local field level commander who commands the use of the men, money, and material in the actual performance of the specific missions assigned.

The responsibility of the field level commander for the satisfactory adherence to sound principles and practices of internal control within his activity cannot be expressed too strongly. While bureau management control,

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[1]Office of the Chief of Naval Operations, Administration of the Shore Activities of the Department of Navy (General Order No. 19), OPNAV NOTICE 5430, 21 May 1959.

internal audit, inspection by bureau staff and other administrative inspections are important aspects of the control system and furnish an independent appraisal and evaluation of the operations of the field command, they do not relieve the field commander of his responsibility for proper maintenance of the control system. This concept of self responsibility must permeate the command so that internal control is actively practiced and respected at all levels.

The field commander has many tools through which he can maintain the integrity and reliability of the control system. Foremost of these tools is his own experience in the field of operations, coupled with the confidence in his ability and judgment by his superiors in the chain of command. Well-trained, professional specialists are available to counsel the commander, both from his own staff and from the staffs of higher commands. The enlightened commander will not hesitate to call upon the capabilities of these specialists, examine their findings, and weigh their recommendations prior to drawing his own conclusion.

The refinements in the application of work measurement through the establishment of engineered time standards has given the field commander a more effective tool with which to evaluate the operations of his command. In addition, properly engineered performance standards enable estimates of backlog and forecasts of anticipated workload to be made with more reliability and accuracy. These statistics are vitally important in the justification of the budget, for substantiation of requests for additional personnel ceilings, and to justify the need for the continued employment of the existing work force.

The government in general and the military in particular have long been the leaders in the advancement of the organizational concept. We cannot operate without it. The elements of internal control are built into our organization from the top down and are the object of critical review and analysis by each of the independent inspection and audit groups which are continually verifying

the degree of compliance to the established elements of control. Within his own staff, the commander should continually stress the importance of a proper management attitude toward internal control and the importance of following a well-defined course of action in setting up the controls and of follow-up to ensure compliance with these controls. Compliance requires full-time effort and direction. Frenzied effort to align the records and controls prior to an inspection or audit is not indicative of whole-hearted compliance nor of good internal control.

The continued shrinkage in the purchasing power of the appropriation dollar, coupled with the drain-off of funds to finance the technological improvements in weapons systems, ships and aircraft, is forcing all levels of command to apply more and more techniques of sound management. These managerial techniques include enlightened interest in financial management, an interest which turns the accounting and reporting system into an even more useful tool of management. Coupled with the successful application of other elements of control, operational efficiency can be raised to meet the onslaught of inflation with minimum loss of effectiveness.[1]

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[1]For a more detailed analysis of the effective tools of control see the Research Report of the 1960 Class of the Navy Graduate Comptrollership Program, The Dollar Problem -- Matching the Mission with Money, George Washington University, Washington, D. C.

CHAPTER V

CONCLUSION

There is really no logical concluding point to a study of internal control. Since the scope of the subject includes the complete span of the business organization, a dissertation on internal control could conceivably be expanded many times over the length of this paper and still not encompass all of the area within its boundaries.

Each of the elements that go into the make-up of the system of internal control is important in its own right and each could be (and actually has been) expanded into full length publications. However, it is the interrelationships between the individual elements combined in one basic control system that give internal control its substance. It is this broad picture of internal control that I have attempted to portray in this thesis.

The necessity for internal control is almost universally recognized. The basic elements are the same in almost every system of control, with the differences being in the varying degrees of emphasis placed on the integral parts of the system. The importance of good judgment in tailoring the various elements of control into an efficient and effective system of control cannot be overemphasized. Controls are expensive to install and even more expensive to maintain. No organization has the manufacture and sale of internal control as its primary objective. Internal control is an operating tool of management and must be appraised in relation to the benefits to be derived from the controls

just as any other tool must be evaluated. Controls can be so established that the cost of the control would far outweigh any possible loss, or can be set up in such a manner that operations would be retarded to the point of failure of the operation. Good judgment must prevail in the establishing of the system of control so as to strike a harmonious balance between control and cost.

Every measure of control should be evaluated in relation to such questions as:

> 1. Does it control something that is worth while to control?
> 2. Does it conform to lines of responsibility, so that individuals may be held responsible for variations and given credit for results?
> 3. Is it in proper perspective to the whole business picture? Are minor items rigidly controlled because such control is feasible, while major items are less rigidly controlled because control is harder to establish?
> 4. Does it meet protective requirements on a practical basis? The complication and cost of protective control must be appraised in relation to possible exposure to fraud, waste, or loss.
> 5. Does it facilitate business operation? Control should be like dikes that direct and control the flow of business transactions; they should not be dams that are more hindrance than help.
> 6. Is it flexible to meet changing business conditions? No business is static. Controls must change as risks and business conditions alter.
> 7. Does it help the business to make more profit? This is the hardest question of all, as the answer may depend on the evaluation of "calculated risks" and the cost and hazards of alternative methods.[1]

While due care and consideration to all details are mandatory in the development of the system of control, continued surveillance of the control system is likewise important. Conditions change. The control system must keep pace with the change in conditions. The passage of time has a weakening effect on the control system and it all too often becomes taken for granted that the various checks and balances which comprise the control structure have kept pace with the change in conditions. This is one of the major causes of

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[1] Cadmus and Child, op. cit., p. 303.

the breakdown in the control systems depicted in the case histories cited in Chapter III.

In addition to continued review to keep pace with changing conditions, management should know the areas where internal control is likely to be at its weakest and to take corrective action to deter any potential wrong-doing. We should let the sad experience of others guide us in the appreciation of what effective control can do for us. Internal control is a tool of sound management -- we should use it wisely.

In the Navy, the elements of internal control are built into our organizations and have withstood the test of time. They are the object of frequent critical review by the various independent inspection agencies of the Navy as well as of the General Accounting Office. It is usually the administration of the system of control rather than the control system itself that has led to abuses of control within the service. The field level commander has been delegated the responsibility for the satisfactory compliance with prescribed measures of internal control within his command -- he must enforce these controls. The field commander should continually stress the importance of a proper management attitude toward internal control so that the concept of self-responsibility for internal control permeates the command. Outside inspection forces and internal audit only aid in the evaluation of the control measures in effect; the command retains the responsibility for satisfactory performance.

No organization can function effectively without the delegation of sufficient authority throughout the organization to enable subordinate levels to carry on the tasks which each has been assigned. With the necessity of delegation comes the need for control. With control comes the assurance that

the policies, procedures and directives of the command are faithfully and effectively carried out; that operating assets are adequately protected and conserved; that there has been a proper administration of functions delegated; that management information has been accurately accumulated and presented; that external regulations have been complied with; and that matters requiring consideration are promptly drawn to the attention of the command.

Effective control at a reasonable cost should be the target of every plan of organization.

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